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I. INTRODUCTION & OVERVIEW

THE EMERGENCE OF A VERTICALLY INTEGRATED OLIGOPOLY IN TELEVISION

This paper examines the impact of three major policy changes in the early and mid-1990s on the production and distribution of video content, primarily broadcast television programming in America: the repeal of the Financial Interest / Syndication rules and the enactment of both the Cable Act of 1992 and the Telecommunications Act of 1996.[1] The paper also considers how the production and distribution of movie programming for cable and theatrical release were affected. It shows that these policy changes led to **the** formation of a vertically integrated oligopoly in television entertainment and a dramatic shrinkage of the role of independent producers of content. The policy changes and resulting alterations in market structure and behavior were not limited to the broadcast sector, however. They also affected the syndication market, cable television and theatrical movies because prime time programming plays a critical role in the overall video entertainment product space. If not amended, these same policy changes could have a major impact upon the ability of independents to offer product through the Internet and other developing digital platforms, including the rapidly approaching digital multi-cast channels.

Over the course of a decade, the content aired on prime time network television, TV syndication, basic and pay cable channels, and theatrical movies came to be dominated by a handful of vertically integrated entities.[2] Dozens of independent entities that produced video

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[1] See Chapter III for a discussion of these policy changes and their impact on industry structure.
[2] See Chapter IV **for** a detailed description of the changes in program sources that followed the policy and structural changes in the industry.

content were replaced by a handful of firms that own major movie studios and television production units, hold multiple broadcast licenses and own the dominant cable networks. The role of independent producers has been squeezed across all distribution platforms.

By two widely accepted economic measures of market concentration, the Herfindahl-Hirschman Index (HHI) and the market share of the top four firms (the 4 Firm Concentration Ration or **CR-4),** the video market has become a concentrated, vertically integrated, tight oligopoly. **As** a result, this oligopoly engages in a number of predatory business practices that both limit competition from independents and deprive the public of new, fresh voices. They foreclose the market to independents by leveraging their vertical market power and by self-supplying product. They exercise their market power as buyers of content (monopsony power) with two practices that are especially damaging to competition from independent producers. The first is that networks often demand that they be given **an** equity participation in an independently developed television **series** in order for it to be placed on the primetime schedule. The second is that basic cable channels owned by members **of** the oligopoly will not pay license fees that are commensurate with the production values and **the** scope **of** licensed rights they demand in independently produced TV movies.

EFFECT OF THE VERTICALLY INTEGRATED OLIGOPOLY ON THE TELEVISION MARKET

Fifteen years ago, theatrical movie studios and broadcast television were almost entirely separate while cable television was **just** developing as a primary **outlet.** In each of these markets, there was a substantial independent sector. Major studios provided about one third of product shown on network prime time television while the networks themselves accounted for just 15%. Non-major studios, known as "independents," supplied nearly one half. One set of independents sold movies to broadcasters. Another set sold series and other programming. A few produced and sold both. Vertical integration has changed that situation.

The vertically integrated major studios and broadcasters now account for over **75%** of broadcast prime time television programming while independents account for less than **20%.** The few independents that get on prime time television produce reality shows, not scripted programming. **As** a result, independents have been virtually shut out of the lucrative syndication market, now accounting for just 18% of all first run syndication programming hours and none of **the** programming hours for shows that have gone into syndication over the last two years.

The economic terrain of cable television has also changed for independents. The vertically integrated media companies own **24** of the top 25 cable channels. The independents' share of pay cable programming also continues to decline as a percentage of programming, dropping by some **15%** since the late nineties. Independent product was also squeezed out of syndication. Independent product is increasingly consigned to **the** far less visible and less financially rewarding basic cable channels where license fees are much lower and in many cases inadequate to cover production costs. Additionally, product placed on basic cable does not have **the** same potential to realize foreign sales that pay cable product enjoys.

The business practices used to accomplish this dramatic shift in the flow of content in the video product space exhibit characteristics that clearly fit the pattern of abuse of market?[3] By controlling distribution and vertically integrating into production, five of the dominant broadcasters have become gatekeepers who favor their affiliated content, restrict access of

[3] ***See*** Chapter V for a discussion of **these** business practices and their effect on source diversity and independent production of video content.

independents to the market, and impose onerous **terms** and conditions on independent producers that have **further** shrunk the sector.

While it is extremely difficult to assess the impact of the changes in the industry on quality, **there** is no doubt that **the** independent sector was a consistent source of innovative and high quality content in both the TV series and movies categories prior to **the** changes in policy.[4] Measured by both popularity and awards, the independents more than hold **their** own when given a chance to reach the public. This quantitative evidence reinforces the celebrated anecdotal evidence – shows like *All in the Family* and *Cosby* – frequently offered about the importance of independent production. It is quite clear that the elimination of independents from the high value TV product spaces – prime time and premium cable – cannot be attributed to poor quality of product. **It** is more readily attributed to changes in **the** structure of the industry and **the** business practices of the dominant, vertically integrated oligopoly.

The key elements **of** the video entertainment product space fit a pattern that the literature on industrial organization describes as **the** exercise and abuse of **market** power. These elements include:

Market Structure and Market Power

- Market shares that have risen to the level traditionally defined **as** a source of concern about concentration setting **the** stage for the abuse **of** market power.
- Substantial barriers to entry in the industry.
- **A** history **of** anticompetitive practices.

Vertical Integration

- Barriers to entry increased by vertical integration.

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[4] See Chapter VI **for** a discussion of **quality.**

- The foreclosure of markets to unaffiliated producers through favoritism of affiliated upstream production and **the** subsequent exit of upstream product suppliers from the market.
- Parallelism and reciprocity among the dominant firms in the oligopoly.
- **A** rush to integrate and concentrate across the sector.

Monopsony (buyer) Power over independent producers.

- The imposition of prices that squeeze unaffiliated producers and terms that shift risk onto those producers.
- Lndications of a decline of quality in product attendant on **the** abuse **of** monopsony power.
- Flooding of downstream outlets with integrated product.

POLICY IMPLICATIONS OF CONSOLIDATION AND INTEGRATION

The swift and massive horizontal consolidation and vertical integration in **the** industry raises a number of concerns. **The** analysis of the economic impact of horizontal concentration and vertical integration can be found across many areas of economic activity, but the unique nature and role of video entertainment raises additional, perhaps even greater concerns in non-economic areas. Television and movies, the former in particular, are fundamental to democratic discourse. Television is the dominant medium in terms of time spent on entertainment and news and information gathering.[5] It is overwhelmingly the choice for national campaign advertising. Entertainment on television can be cultural, educational or political. Theatrical releases have a prominent **role** in **the** public discourse as well, which films such as ***Crash*** and ***The Passion of the Christ*** have demonstrated in recent years.

[5] Cooper Mark, ***Media Ownership and Democracy in the Digital Information Age*** (Palo Alto: Stanford Law School Center for Internet and Society, ***2003).***

Television and movies play an important part in the marketplace of ideas. **A** nation that prides itself on freedom of speech and diversity while simultaneously issuing exclusive licenses to private firms to broadcast content faces a dilemma. The issuance of a handful of broadcast licenses in each market in America creates a privileged class of speakers through government action. Local governments issue franchises to cable TV operators, which are even more scarce than broadcast licenses on a city-by-city, county-by-county basis.

How one promotes diversity with such a small number of electronic voices, without dictating what content broadcasters should air, becomes a major source of concern. If those very valuable and powerful government-granted platforms for reaching the public become the core of a tight oligopoly that dominates other areas of expression, the concern is compounded.

If dictating content is ruled out by First Amendment free speech concerns, but policy makers continue to strive for diversity, then the primary option is to build media market structures that disperse the opportunity to speak as much as possible within the confines of the granting of licenses and franchises. The principle on which this approach stands is simple. By ensuring a wider opportunity to put content before the public, diversity and discourse are stimulated without dictating the substance of the content supplied.

POLICIES TO PROMOTE DIVERSITY

For much of the twentieth century, the Congress and the Federal Communications Commission pursued this goal of diversity by simultaneously dispersing ownership of production and distribution of content. The number of media outlets that could be owned by a single entity was restricted both within a market (the local television multiple ownership rule)[6] and across the nation (a national cap) by the national television multiple ownership rule.[7] The amount of content aired in prime time that any given network could own was limited as well by the Financial Interest and Syndication Rules (Fin-syn) and the Prime Time Access Rules.[8] Similarly, consent decrees in cases brought by the Department of Justice mirrored the Fin-Syn rules.[9] Other FCC rules prevented Broadcast license holders from owning other **types** of media outlets – e.g. newspapers and cable TV systems (cross. ownership limits)[10] -- and restricted their ability to engage in cross-media ownership (e.g. radio).[11] The result was a substantial dispersion **of** ownership of content.

In the 1990s, the two primary policies to promote diversity of ownership of content in broadcasting were eliminated or cut back. The Financial Interest and Syndication Rules (Fin-Syn) that governed prime time programming were allowed to expire and the consent decree was also vacated – allowing broadcasters to own as much programming as they wanted. The

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[6] 47 C.F. R. 73.355(b), the duopoly rule, lifted the ban on multiple station ownership, but 47 C.F.R. 73.658(g), the dual network **rule,** restricted **the** combinations of television stations, to disallow dual or multiple network ownership that involves a combination between ABC, CBS, Fox, or NBC. Citations to the rules are currently being reviewed, which generally relaxed the restrictions on cross ownership in **the** 1990s and are the latest in **the** evolving regulatory structure.

[7] 47 C.F. R s 73.3555(e)

[8] The two rules have always been closely linked ***see*** Amendment of **Part** 73 of the Commission's **Rules** and Regulations with Respect to Competition and Responsibility in Network Television Broadcasting, 23, FCC 2d 282 (1970). Amendment of **Part** 73 of the Commission's Syndication and Financial Interest Rule, 47 FR 32959 (1982), **as** they were in the court case that led to their ultimate expiration, ***see*** Shurz Communication Inc. v. FCC 982 F. 2d 1043, 1049 (7th Cir. 1992).

[9] Identical consent decrees were entered against the three major networks, which followed the Fin-syn rules closely. These **were** vacated when in the early 1990s, as the Fin-syn rules were allowed to expire**...**

[10] 47 C.F. R. s 73.3555(d), cross-ownership of broadcast states and newspapers, prohibits the common ownership of a daily newspaper and a broadcast station in **the** same market.

[11] 47 C.F.R. 73.3555(c), the radio-television cross -ownership rule, limits the number **of** TV and radio licenses that can be held within a market.

limits on multiple station ownership were relaxed – allowing them to own two stations in the nation's largest and most important markets. A third policy also gave broadcasters the right to carriage on cable systems (must-carry/retransmission).[12] The terrain of the American media landscape was dramatically altered by these policy changes as the broadcasters moved quickly to use these three new sources of leverage in the video market.

Whether or not Congress anticipated the powerful effect that the policy changes of the 1990s would have on diversity of ownership of programming is unclear. Although the FCC has created records on these issues in its proceedings subsequent to the changes in policy, the courts have remanded several of its rules,[13] leaving their regulatory status in flux and Congress has included a provision that requires frequent review of the rules.[14]

The FCC continues to have the authority to implement restrictions on media ownership to accomplish the goals that Congress has set in legislating media policy,[15] with the exception of the national multiple ownership rule. To the extent that Congress continues to embrace the goal of diversity, the current situation and how the policy changes of the 1990s created it are what matters now. Moreover, since Congress ordered the FCC in the Telecommunications Act of 1996 to periodically review its rules, the FCC could conclude that

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[12] Cable Television Consumer Protection and Competition Act of 1992, Pub. L. No. 102-385, 106 Stat. 1460 (1992).
[13] Indeed, all of the major structural rules written in the late 1990s have been remanded by the court (broadcast multiple station limits, cable horizontal limits, newspaper cross ownership) or overridden by Congress (national cap).
[14] The 1996 Act provided for a biennial review (Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996). This was later extended to four years (*FY2004* Consolidated Appropriations *Act* (Public Law 108-109, 118 Stat. 3 et seq. Section 629) and prohibited the FCC from further reviewing the national cap.
[15] As with the other rules overturned by the courts, in the case of the Fin-Syn rules, while the courts rejected the specific FCC rule (*Schurz* Communications *Inc. v. FCC* 982 F. 2d 1043 (7th Cir. 1992), it did not preclude the writing of an alternative rule. To date, the FCC has elected not to do so.

the rule changes it has implemented with agency discretion have harmed diversity, a goal that Congress continues to embrace. The FCC could re-institute those policies that successfully promoted source diversity in the past or it could seek new policies that will promote source diversity in the future.

This paper shows that the current policies are not promoting independent production of video content on **the** major television platforms. Understanding the impact of past rule changes is the first step in the process of re-examining **the** decline of sources diversity on television. That is the subject of this paper. While the purpose of this paper is not to recommend specific policy changes, it is clear that if policymakers still believe in source diversity, then a change in policy that directly alters the structure and conduct of the vertically integrated oligopoly are is necessary.

OUTLINE

The paper is based on four sources of **data:**

- Over a dozen interviews with executives involved in the production of content for television, theatrical and video release.
- **A** review of the academic literature
- **A** review of the trade and popular press
- **A** database that charts market shares in every major domestic and foreign platform for exhibition and release of audiovisual product.

Chapter II outlines **the** basic issues and analytic approaches. It first describes **the** product space **1 am** studying and then the analytic approach that **I take.**

Chapter III describes the policy changes and subsequent changes in market structure and conduct of the vertically integrated video entertainment product space. First it examines the impact of the repeal of the Fin-Syn rules on **the** market structure of the video entertainment product spaces. Then it surveys the current state of the video entertainment product space.

Chapter IV examines the change in the sources of content that resulted from the change in market structure. It begins with an analysis of prime time and broadcast programming. Then it turns to the patterns of distribution of TV movies, which includes a great deal of cable content. Finally it assesses the importance of prime time broadcasting to the overall video entertainment product sector.

Chapter V discusses the impact of the market structure on **the** production and distribution of content. The focus is on the gate-keeping role of the vertically integrated movie/broadcast/cable companies.

Chapter VI reviews that debate over the impact **of** the vertically integrated oligopoly on the **quality** of programming.

Chapter VII offers some concluding observations on the role of **the** Internet.

II. DEFINING THE PRODUCT SPACE AND ANALYTIC APPROACH

THE OBJECT OF STUDY

This is a study of the industrial organization of the video entertainment sector – theatrical movies, all forms of television and the sale and rental of tapes and DVDs – in the United States. Because the sector is complex, I adopt the following definitions. The sector consists of **six** primary channels for the distribution of content:

- **theatrical movie** releases,
- **prime time** airing of movies and series on broadcast television,
- **syndication** on broadcast television in non-prime time slots of both movies and series,
- movies and series aired on **pay cable,**
- movies and series aired on **basic cable** networks,
- **Home Video** – i.e. sale/rental of video for viewing on VCR and DVD players.

I refer to the overall sector made up of the six distribution channels as the **video entertainment product space.** The Internet has just begun to be used as a means of redistributing video product that was originally released through one of the other six outlets. While there are clear indications that it will change the current terrain of the video entertainment product space in the long run, there are also clear indications that it will not deconcentrate the sector. Already, the networks are multicasting current primetime programming through their websites and Internet protocol television (IPTV) channels are coming on line. Internet video on demand services (VOD), such as Cinema Now and Movielink, are gaining visibility and subscribers as broadband service penetrates deeper into the consumer market, but the same content producers dominate. Broadcasters are poised to receive a substantial increase in their ability to distribute content with the transition to digital multicasting. The current single channel with **be** expanded by the granting of rights to **use** spectrum to broadcast up to six channels digitally. **As** such, there is growing concern that the same entities that dominate the traditional channels of physical distribution of video entertainment product will extend their dominance to the new Internet and digital distribution channels.

The nature and relationship between these channels has changed over time. Terms of art once applied have stuck, even though they may no longer technically describe the distribution channel.

Theatrical distribution of movies has been around the longest, with the commercial industry stretching back to the early part of the 20" century. Television emerged in the 1950s and 1960s. Cable arrived in the 1970s and 1980s. Distribution of video tapes began in the 1980s and exploded with the advent of DVDs in the early 2000s.

Traditionally, television was divided between broadcast and cable to reflect **the** different means of delivery. Broadcasters sent signals over the air from TV transmitters (stations) that were licensed by the FCC. Cable signals were sent from a head end through a wire, the laying of which was franchised by a local entity. Today, although broadcast signals are still available over-the-air, most American households (80% to 90%) get the broadcast product through the cable wire or from satellites.

Prime time on broadcast TV was always a focal point of policy because of the huge audience and resources it commanded. Prime time was controlled by the networks, which also held licenses to operate TV stations in the largest markets. They created national networks by affiliating with independent license holders in markets where they did not hold broadcast licenses directly. The major networks – ABC, NBC and CBS, reach virtually every home in America. Fox is **a** national network as well, although it may be available in somewhat fewer homes.

Although cable has always been a subscription service it split into two different distribution channels when pay cable services, **like** HBO, developed **the** ability to charge a premium for programming and basic cable became advertiser supported, mimicking broadcast television. Historically, one could **draw** a clear line between production of content by movie studios and exhibition – **the** presentation to the public of product – in theaters. The distinction breaks down with live television – the broadcast is simultaneously produced **and** distributed Television also changes the nature of the exhibition from a public space to a private space, although it is still shared in the sense that programming is watched simultaneously, but separately, by large numbers of people. The sale/rental of videos (and the recording of programming) for home viewing (referred to as Home Video) extended the change from a public to a private experience by allowing people to choose when to watch.

ANALYTIC APPROACH: STRUCTURE, CONDUCT PERFORMANCE

The paper applies a framework **of** analysis known as the structure-conduct-performance paradigm (see Exhibit 11-l),[16] which has been **the** dominant approach to industrial organization analysis for over three-quarters of a century. The premise is simple.

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[16] Scherer, F. M. and David Ross, Industrial ***Market Structure and Economic Performance*** (Boston, Houghton Mifflin: 1990); **Shepherd,** William, G., ***The Economics of Industrial Organization*** (Prentice Hall, Engelwood Cliffs, N.J., 1985).

The analysis **seeks** to identify the conditions that determine the performance of markets.[17] It starts with basic conditions.'* On the supply-side these include factors such as technology, product durability, business attitudes and the legal framework. On **the** demand side factors such as price elasticity, cyclical/seasonal patterns, and purchasing methods are 'included. These interact with characteristics of the market structure,[19] such as the number.,

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[17] Id., p. **4.**

> **We** seek to identify sets of attributes or variables that influence economic performance and to build theories detailing the nature of the links between these attributes and end performance. **The** broad descriptive model of these relationships used in most industrial organization studies was conceived by Edward S. Mason at Harvard during the **1930s** and extended by numerous scholars.

Shepherd, William, G., ***The Economics of Industrial*** **Organization** (Prentice Hall, Engelwood Cliffs, N.J., 1985), p. 5, presents a similar view.

[18] Scherer and Ross, p. 5.

> Market structure and conduct are also influenced by various basic conditions. For example, on the supply side, basic conditions include the location and ownership **of** essential raw materials; the characteristics of the available technology (e.g. batch versus continuous process productions or high versus low elasticity of input substitution); the degree of work force unionization; the durability of the product; **the** time pattern **of** production (e.g. whether goods are produced to order **or** delivered from inventory); the value/weight characteristics of the product and ***so*** on. **A** list **of** significant basic conditions on **the** demand side must include at least the price elasticity of demand at various prices; **the** availability of (and cross elasticity of demand for) substitute products; the rate of growth and variability over time of demand; the method employed by buyers in purchasing (e.g. acceptance of list prices as given versus solicitation of sealed bids versus haggling); and **the** marketing characteristics of the product sold (e.g. specialty versus convenience shopping method).

[19] Scherer and Ross, p. **5.**

> Conduct depends in turn upon the structure of **the** relevant market, embracing such features as **the** number and size distribution of buyers and sellers, the degree of physical or subjective differentiation prevailing among competing seller's products, the presence or absence of barriers to entry of new firms, the ratio of fixed to total costs in the **short** run for a typical **firm, the** degree to which firms are vertically integrated **from** raw material production to retail distribution and the amount of diversity or conglomerateness characterizing individual firms' product lies.

Exhibit 11-1:

The Structure–Conduct–Performance Paradigm

BASIC CONDITIONS

Supply

Raw material
Technology
Unionization
Product durability
Value/Weight
Business attitudes
Legal framework
Price Elasticity

Demand

Price elasticity
Substitutes
Rate of growth
Cyclical and seasonal Character
Purchase method
Marketing type

MARKET STRUCTURE

Number of sellers and buyers
Product differentiation
Barriers to entry
Cost structures
Vertical integration
Diversification

PUBLIC POLICY

Taxes and subsidies
International trade
Regulation
Price Controls
Antitrust policy
Information

CONDUCT

Pricing behavior
Product strategy and advertising
Research and innovation
Plant investment
tactics

PERFORMANCE

Production and allocative efficiency
Progress
Full employment
Equity

SOURCE: Scherer and Ross, F. M., and David Ross, *Industrial Market Structure and Economic Performance* (Houghton Mifflin Company: Boston, 1990), p. 5.

and the size of sellers and buyers, product differentiation, cost structures and vertical integration (the relationship of production and distribution), to determine the conduct of the market participants. The **key** types of conduct include pricing behavior, product strategy and advertising, and legal tactics.[20] Conduct determines performance, traditionally measured in terms of pricing and profits, but increasingly viewed as quality and the nature and speed of innovation.

One of the key features of the structure-conduct-performance paradigm is that it recognizes the importance of public policy. Policies, such as antitrust enforcement, regulation, or taxation and subsidization, can directly affect structure and conduct, thereby altering performance.

HORIZONTAL MARKET POWER

The characteristic of market structures that received most public policy attention is horizontal market power. The concern is that if markets become concentrated – i.e. where a few players have a large market share – competition is dulled. Rather than compete to produce the best product at the lowest price, one large entity may be able to set prices **up** or otherwise affect output, without a sufficient response from others to discipline such behavior. With small numbers of competitors, they may accomplish the **same** thing by consciously paralleling each other's behavior. **Thus,** the Department **of** Justice defines market power as

[20] Scherer and Ross, p. **4.**

> Performance in particular industries or markets **is** said to depend upon **the** conduct of sellers and buyers in such matters **as** pricing policies and practices, overt and taciturn interfirm cooperation, product line and advertising strategies, research and development commitments, investment in production facilities, legal tactics ***(e.*** g. enforcing patent rights), and so on.

"the ability profitably to maintain prices above competitive levels for a significant period of time.. . Sellers with market power also may lessen competition on dimensions other than price, such as product quality, service or innovation."[21]

Pure and perfect competition is rare, but the competitive goal is important.[22] Therefore, public policy pays a great deal of attention to the relative competitiveness of markets as well as the conditions that make markets more competitive or workably competitive. Knowing exactly when a market is "too" concentrated is a complex question. The Department **of** Justice calculates an index called the Herfindahl-Hirschman Index (HHI) to categorize markets (see Exhibit II-2). This index **takes** the market share of each firm, squares it and sums it. It considers a market with an HHI above 1000 to be concentrated. This is the equivalent of a market with fewer than the equivalent of 10-equal sized firms. It considers a market with fewer than the equivalent of approximately 5.5-equal sized firms (HHI = 1800) to be highly concentrated. Markets with an HHI between 1000 and 1800 are considered moderately concentrated.

[21] Department of Justice/Federal Trade Commission, ***Merger Guidelines*** (1997).

[22] Scherer and Ross, p. 16-17.

> In modem economic theory, a market is said to **be** competitive (or more precisely, purely competitive) when the number of firms selling a homogeneous commodity is so large, and each individual firm's share of the market is so small, that no individual firm finds itself able to influence appreciably the commodity's price by **varying** the quantity of output it sells.. . Homogeneity of the product and insignificant size of individual sellers and buyers relative to their market (that is, ***atomistic*** market structure) are sufficient conditions for the existence of pure competition, under which sellers **possess** no monopoly power. Several additional structural conditions are added to make competition in economic theory not only "pure" but "perfect." The most important is **the** absence of barriers to entry **of new** firms, combined with mobility of resources employed.

Exhibit 11-2:
Describing Market Concentration for Purposes of Public Policy

DEPARTMENT OF JUSTICE MERGER GUIDELINES	TYPE OF MARKET	EQUIVALENTS IN TERMS OF EQUAL SIZED FIRMS	HHI	4-FIRM SHARE (%)
	Monopoly	1 Firm with 65% or more	4250<	100
	Duopoly	2	5000<	100
↑		5	2000	80
HIGHLY CONCENTRATED	Tight Oligopoly		1R00 OR MORE	
		6	1667	61
UNCONCENTRATED 1	Loose Oligopoly	10	1000	40
	Atomistic Competition	50	200	8

Sources: U.S. Department **of** Justice, *Horizontal Merger* Guidelines, revised **April** 8, **1997, for a** discussion **of** the HHI thresholds; Shepherd, William, G., ***The Economics** of Industrial Organization* (Prentice **Hall,** Englewood Cliffs, N.J., 1985), for **a** discussion of 4 firm concentration **ratios.**

Many economists describe markets in terms of **the** market share of **the top** four firms. Shepherd describes these thresholds in terms of four-firm concentration ratios as follows:[23]

> Tight Oligopoly: The leading four **firms** combined have 60-100 percent of **the** market; collusion among them is relatively easy.
>
> **Loose** Oligopoly: The leading four firms, combined, have 40 percent **or** less of the market; collusion among **them** to **fix** prices is virtually impossible.

Although the overlap is not perfect, there is a close correspondence between **these** two approaches. **A** highly concentrated market is called a tight oligopoly.[24] **A** moderately concentrated market is called a loose oligopoly.

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[23] Shepherd, p. **4.**

MONOPSONY POWER

A second economic concept that plays **an** important part in the video entertainment product space is that of monopsony power. Monopsony power is the flip side of monopoly power. Monopoly power is the power of a seller to dictate prices, terms and conditions **as** a seller of goods and services to the public. Monopsony power is the power of downstream buyers of inputs to create products to sell to the public and to dictate the prices, terms and conditions on which they buy those inputs. If the upstream suppliers lack alternatives, they may be forced to accept terms that under compensate them or force them to bear extra risk. The downstream buyers have market power over the upstream sellers of the product. This can result in the production of fewer or inferior products for sale downstream.

Although monopsony has not been the focal point of much antitrust action, it is more likely in precisely the **type** of sector like the video entertainment product space, where inputs are specialized

> Monopsony is thought to be more likely when there **are** buyers of specialized products or services. For example, a sports league may exercise monopsony (or oligopsony) power in purchasing the services of professional athletes. An owner of a chain of movie theaters, some of which **are the sole** theaters in small towns, may have monopsony power in the purchase or lease of movies. Cable TV franchises may exercise monopsony power in purchasing television channels that will be offered to their subscribers.[25]

VERTICAL INTEGRATION AND LEVERAGE

A third key characteristic of many industries is the extent **of** vertical integration. In many industries the act of producing a product *can* be readily separated from its distribution and sale. Production is referred **to** as the upstream, distribution and sale are referred to as the

[24] Shepherd, p. **4.**
[25] Sullivan and Grimes, p. 138.

downstream. Vertical integration occurs when both activities **are** conducted by one entity. Because vertical integration involves the elimination of a (presumably market-based) transaction between two entities it has been the focal point of a great deal of analysis. Economic efficiencies are frequently claimed for vertical integration due to the elimination of transaction costs. Others fear inefficiency and potential abuse of the ability to leverage vertical market power that can result from excessive or unjustified vertical integration.

The classic concern is that distributors of content, who are also producers, favor their own content at the expense of the content of unaffiliated producers. Vertical integration may become the norm in the industry, making it difficult for unintegrated producers to survive. Vertically integrated entities may capture the market for inputs, making it difficult for independent entities to obtain the factors of production necessary to produce product. **Also,** with vertically integrated entities dominating a sector, reciprocity and forbearance rather **than** competition may become the norm.

CONCLUSION

The remainder of this paper documents the emergence of a vertically integrated, tight oligopoly in the video entertainment product space. It shows that when public policies that prevented the exercise of market power were relaxed or eliminated, the conditions for the exercise of market power were quickly created by mergers and acquisitions and changes in behavior. The industry became a vertically integrated, tight oligopoly. Vertical leverage was used to eliminate independent production of prime time content. Monopsony power was exercised to squeeze independent **film** production into a very narrow, niche space on basic cable channels.

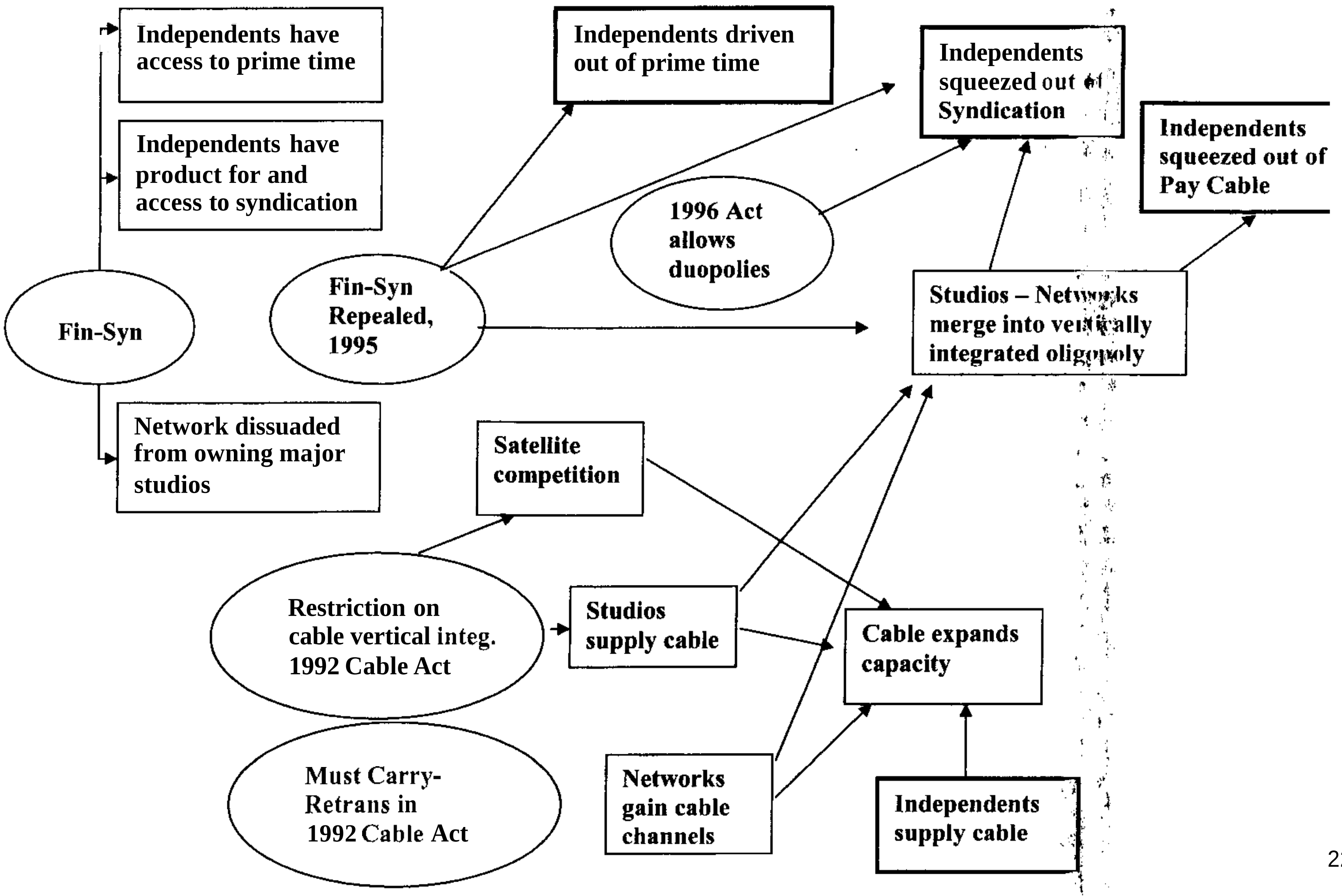
III. PUBLIC POLICY AND THE EMERGENCE OF A VERTICALLY INTEGRATED OLIGOPOLY IN VIDEO ENTERTAINMENT

THE REPEAL OF FINANCIAL AND SYNDICATION RULES TRIGGERS HORIZONTAL CONCENTRATION AND VERTICAL INTEGRATION

,**At** the end of the 1980s, policies to **disperse** ownership in broadcast television were in place. Though they had been debated intensely throughout the 1980s, the policies remained to limit holders of broadcast licenses to one to a market. These stations were known as O&Os (owned and operated). Holders of broadcast licenses could have **O** & **O** stations that reached no more than **25%** of the nation's television households. The national broadcast networks were restricted in the amount of content that aired in prime time they could **own** and their participation in the syndication of non-prime time programming (the Financial and Syndication Rule). The broadcast networks filled out their national networks by entering into affiliation agreements with stations they did not own or operate. There were extensive **rules** that governed the relationships between the affiliated stations and the networks.

Exhibit III-1 identifies the key policy changes (ovals) and the structural and conduct changes that followed (rectangles) in the 1990s. The primary policy that triggered the vertical integration in the industry was the decision **of** the FCC to allow the Financial and Syndication Rules to lapse, rather than write rules that would pass court scrutiny. ***(see*** Exhibit III-1). **In** retrospect, it is quite clear that

Exhibit 111-1:
The Impact of 1990s Policy Changes on Independents in the Television Market



the Financial and Syndication rules, which restricted the amount of broadcaster-owned programming in prime time, had a major effect on the diversity of not only the broadcast television market, hut television in general. When the rules were eliminated in the mid-1990s, broadcasters moved to replace the lion's share of independent programming with content they produced. Self-dealing became the predominant mode of operation.

Ironically, the impact was more profound than the direct effect on prime time. At the time that the Fin-Syn rules were relaxed, restrictions on vertical integration in the cable industry were implemented. Cable operators were restricted in the percentage of capacity on their systems they could fill with programming they owned. In the Cable Consumer Protection Act **of** 1992 they were also required to make their own programming available to competing delivery systems (the program access rules). As a result of the improved access to programming, satellite competition, which had been anticipated in the 1984 Cable Act, finally increased its market share. Satellite was a digital technology with greater capacity than cable. The cable industry responded by deploying its own digital capacity. Thus, just as the broadcast space was closing, the cable space opened for the majors and independents. The studios, which had been prevented from integrating with broadcasters, funded and supplied programming for cable channels. Given their structure, they could not provide nearly all the programming that a 2417 channel required. A substantial market for independent movie production opened **up.**

Majors and independents were not the only beneficiaries of the 1992 Cable Act. The Act also gave the broadcasters a wedge into the cable platform, with the must carry/retransmission rules. Cable operators needed to cany the major broadcast networks to make their basic subscription packages attractive to the public. The Cable Act of 1992 gave the broadcasters